No. 18258

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

McCullough Tool Company,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

PETITIONER'S REPLY BRIEF.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Cases

Statutes

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Summary of Argument.

I.

The obligation of the petitioner under the Modification Agreements was absolutely unconditional. No rights of termination in the petitioner survived the Modification Agreements since such rights of termination would be inconsistent with the specific undertaking of the petitioner in the Modification Agreements and since such Modification Agreements specifically provided that any provisions of the prior License Agreement which were inconsistent with the Modification Agreements should have no further effect. Further, it was the intention of the parties that the obligations of the petitioner be unconditional and the petitioner consistently treated them as such thereafter.

II.

The Modification Agreements constituted notes in accordance with every legally accepted definition of that term were notes within the meaning of Section 439(b)(1) of the 1939 Internal Revenue Code.

ARGUMENT.

I.

The Language and Intent of the Modification Agreements of December 28, 1950, Completely Abrogated and Nullified the Petitioner's Rights of Termination Found in the Prior License Agreements.

The respondent argues that certain rights of termination granted to the petitioner in the original License Agreements of January 1, 1944 and October 1, 1947 [Exs. B and D] prevented petitioner's obligations under the several Modification Agreements [Exs. C, E, F, G, H, I and J] from being unconditional and thereby in turn prevented the petitioner's obligations under the Modification Agreements from constituting an "outstanding indebtedness" and the Modification Agreements from being "notes". Since both are required to entitle the petitioner to include its obligations under the Modification Agreements in "borrowed capital" for excess profits tax purposes under Section 439(b)(1) of the 1939 Internal Revenue Code, the respondent concludes that the petitioner is not so entitled. The respondent is wrong.

The pertinent provisions of the Modification Agreements and the License Agreements are as follows:

1. The Modification Agreement [Ex. C] having reference to the Bullet patent License Agreement of January 1, 1944 [Ex. B] provides as follows with respect to petitioner's obligation to pay for the rights in the patents:

> "1. Paragraph 6 of said Agreement of January 1, 1944 is modified to read as follows:
>
> '6.
>
> 'In consideration of the rights in and to the patents and patent applications transferred, assigned

and sold by the Parties of the First Part (I. J. McCullough and O. J. McCullough) to the Party of the Second Part (petitioner), the Party of the Second Part (petitioner) hereby agrees to pay to the Parties of the First Part (I. J. McCullough and O. J. McCullough), in addition to all other payments heretofore made hereunder, $20,000.00 per month on the 28th day of each calendar month, commencing on the 28th day of December, 1950, for a period of six years and one month. The last of said monthly payments shall be due and payable on the 28th day of December, 1956. One-fourth of each of said monthly payments, or $5,-000.00, shall be paid to O. J. McCULLOUGH, and three-fourths of said monthly payments, or $15,000.00, shall be paid to I. J. McCULLOUGH. The parties are agreed that the total of these payments, $1,460,000.00, shall be the full remaining price to be paid by the Party of the Second Part (petitioner) for the complete and absolute ownership of the patents and patent applications described in Exhibit "A".' "

2. The provision of the Bullet patent License Agreement of January 1, 1944 [Ex. B] providing for a right of termination in the licensee thereunder is as follows:

"7.

"The Licensee shall have the right to terminate this agreement upon first giving ninety day notice in writing to the Licensors to cancel and terminate this agreement together with all rights, licenses and obligations hereunder, provided, however, that no such termination or cancellation shall relieve the Licensee from the payment of any royalty due and payable to the Licensors at the time of such termination."

3. The Modification Agreements [Exs. E, F, G, H, I and J] having reference to the Jet patent License Agreement of October 1, 1947 [Ex. D] provide as follows (except as to parties and amounts) with respect to the petitioner's obligation to pay for the rights in the patents:

> "1. In lieu of the provisions for payment set forth in the said 'License Agreement' of October 1, 1947, by which the said inventions and patent applications were sold to the Corporation, insofar as they relate to 'I.J.M.' under the said assignment, the Corporation agrees to pay to 'I.J.M.' the sum of $717,500.00. Said amount shall be paid in equal monthly installments of $3,500.00, payable on the 28th day of each month, commencing on the 28th day of December, 1950 and ending with a payment on the 28th day of December, 1967."

4. The provision of the Jet patent License Agreement of October 1, 1947 [Ex. D] providing for a right of termination in the licensee thereunder is as follows:

> "XIV.
>
> "LICENSEE shall have the right to terminate this Agreement at any time upon the giving of sixty (60) days prior written notice thereof to LICENSORS: provided however, that in the event this Agreement is terminated in any manner provided in this Agreement before January 1, 1951, LICENSEE expressly covenants that it will not employ, or in any manner make use of, either directly or through any agent, subsidiary or affiliate, any of the information, data, or 'know-how' disclosed to LICENSEE by LICENSORS respecting the tools or methods embraced within the subject matter of this Agreement until after January 1, 1951."

5. The Modification Agreement of December 28, 1950 having reference to the License Agreement of January 1, 1944 [Ex. C] provides as follows:

> "2. It is agreed by the parties hereto that any and all provisions of said Agreement of January 1, 1944 which are *inconsistent with this Modification Agreement* shall have no effect. Said Agreement of January 1, 1944 has been considered by the parties thereto as an absolute assignment or sale of the subject matter thereof. That Agreement together with this Modification thereof shall be similarly construed hereafter." (Emphasis supplied.)

6. Each of the Modification Agreements having reference to the License Agreement of October 1, 1947 [Exs. E, F, G, H, I and J] provide as follows:

> "2. It is agreed by the parties hereto that any and all provisions of said Agreement of October 1, 1944 which are *inconsistent with this Modition Agreement* shall have no effect. Said Agreement of October 1, 1947 has been considered by the parties thereto as an absolute assignment or sale of the subject matter thereof. That Agreement together with this Modification thereof shall be similarly construed hereafter." (Emphasis supplied.)

As set forth above, paragraph 1 of each of the Modification Agreements contains a clearcut and completely unambiguous promise on the part of the petitioner to pay sums certain at determinable future times to the several individuals entitled thereto. Any right to terminate its obligation prior to the full payment of the sums specified in the Modification Agreements are absolutely inconsistent with the petitioner's undertaking to pay the specified sums provided for in the Modification Agreements. Therefore, the language contained in paragraph 2 of the several Modification Agreements invalidating any language of the prior License Agreements which is inconsistent with the Modification Agreements absolutely and conclusively abrogated and nullified the previously existing rights of termination. The petitioner contends that the several agreements, when read together, cannot be otherwise construed.

Not only does the only possible construction of the several documents involved support the petitioner's contention that the rights of termination were made ineffective by the Modification Agreements, but such contention is also supported by all of the evidence with respect to the intention of the parties, both prior and subsequent to the execution of the Modification Agreements.

In testifying before the Tax Court, Mr. I. J. McCullough, the President of the petitioner stated as follows:

> "They (the several individuals entitled to royalties under the License Agreements of January 1, 1944 and October 1, 1947) stated that they had been advised that the Commissioner of Internal Revenue had revoked his order or regulation, whatever it was, whereby that the capital gains treatment of their royalty income would not be treated as such and therefore, they had been advised by their tax counsel that their best move or their best—his best judgment was they should offer the patents to the corporation to buy them outright for a fixed sum of money." [Tr. 16.]

The order or regulation to which Mr. I. J. McCullough was referring was Mimeograph 6490 1950-1

C. B. 9, wherein the Commissioner of Internal Revenue had withdrawn his acquiescence to *Edward C. Myers* (1946), 6 T. C. 258, and substituted therefor a nonacquiescence and in effect ruled administratively that after 1950 royalties received under a License Agreement which were measured by the use of patents and which were paid over a period which was coterminous with the life of the patent would be treated as ordinary income rather than capital gain. In effect what the parties intended was to preserve their capital gain status with respect to the payments received from the petitioner by selling their patents and inventions to the petitioner for a fixed sum rather than licensing them for a royalty based on use. It is submitted that the survival of a right of termination in the petitioner is inconsistent with such intention.

Further, the petitioner contends that its treatment of the obligations under the Modification Agreements subsequent to the execution thereof is inconsistent with the survival of any right of termination.

As the petitioner has pointed out in its opening brief, pages 17, 18 and 19, the petitioner, without exception, has consistently treated the Modification Agreements as imposing upon it fixed and unconditional obligations to make the payments set forth therein to the several individuals involved. Immediately after the execution of the Modification Agreements, the petitioner made entries on its books and records acknowledging to whomever it might concern its liability for the full amount of the purchase price of the patents which was payable under the Modification Agreements. Reference is again made to Exhibits L and M herein in which the petitioner in clear and unmistakable terms set up on its books and records its liability under the Modification Agreements. The language used by the petitioner in acknowledging this liability is as follows:

> "To record liability for purchase of (Bullet and Jet) patents under Agreements of December 28, 1950" [Ex. L herein] and "Liability for purchase of patents". [Ex. M herein.]

On one occasion the petitioner made advance payments to one of the individuals entitled to payments under the Modification Agreements regarding the so-called Jet patents. Reference is again made to petitioner's Exhibit 5 herein, which evidences the advance payment to James M. Gray, one of the individuals entitled to payments under the Modification Agreements, of the amount of $19,950. This amount represented 60 monthly payments and it is inconceivable that petitioner would have made such advance payments to any creditor if it considered its liability therefor to be merely a terminable one.

Further, all of the payments called for by the Modification Agreements with respect to the Bullet patents were made by the petitioner to the individuals entitled thereto in strict conformity with the provisions of the Modification Agreements to the end that such agreements [Ex. 2 herein] were on December 28, 1956 completely executed. Also all of the payments set forth in the Modification Agreements with respect to the Jet patents have, from the date of execution of such agreements to the present time, been made by the petitioner in strict accordance with the terms of such Modification Agreements. There is not one iota of evidence in the record in this case that any of the parties at any time intended that the petitioner had any right whatsoever to terminate its obligation to make the payments set forth in the Modification Agreements to the several individuals entitled thereto.

The respondent's argument that such a right of termination survived the Modification Agreements flies in the face of not only the only reasonable interpretation of the language of the Modification Agreements, but also all of the evidence to the contrary and to very reason itself.

Further, it is clearly evident that the Tax Court, in ruling that the petitioner was entitled to take depreciation deductions after the execution of the Modification Agreements, was fully convinced that the petitioner was obligated to make the full amount of the payments set forth in the Modification Agreements. In its opinion the Tax Court states as follows:

> "What is material we think is that the Modification Agreements of 1950 substituted for petitioner's then existing obligation to make payments of royalties dependent upon gross receipts over the lives of the patents, new obligations to make payments of *sums certain* over specified shorter periods of time. Such substitution of obligations differing materially in extent and time are mutually supporting considerations giving rise to valid *and enforceable contracts*." [R. 42.] (Emphasis supplied.)

and further:

> "No title was reserved by the transferors so far as we can see and petitioner *did not impose any conditions as to payment*, except to specify the time when they should be made." [R. 48.] (Emphasis supplied.)

The Tax Court's opinion that the petitioner was unconditionally obligated under the Modification Agreements to make payments of *sums certain* is completely and entirely inconsistent with the existence of any right of termination. It cannot be said that the petitioner was obligated to make payments of *sums certain* if it had at any time prior to complete payment the right to terminate its obligation and make no further payments.

The respondent in its brief, page 19 thereof, misconstrues the basic contention of the petitioner. It is not the petitioner's contention that any right of termination is inconsistent with the sale of property. Contracting parties can, of course, agree upon a right of termination or a right in the buyer to require the seller to repurchase. What the petitioner does contend is that under the facts of this case any right of termination in the petitioner is inconsistent with the undertakings of the petitioner in the several Modification Agreements to pay fixed and certain sums of money to the several individuals involved, and that, therefore, the rights of termination provided for in the prior License Agreements are of no further effect because of the language in the Modification Agreements specifically so providing. The Oregon, California and Kansas cases which the respondent cites in support of its general rule of law which is not here involved are therefore inapposite to the issues involved in this case and need not be discussed by the petitioner.

II.

The Modification Agreements Constituted Notes Within Every Legally Acceptable Definition of That Term.

The respondent additionally contends that the written instruments here in question are not "notes". The respondent bottoms its arguments in this connection, first of all, on the fact that the rights of termination which respondent contends survived the Modification Agreements negative the element of unconditionality and, therefore, prohibit the documents from being notes. The petitioner contends that it has clearly demonstrated that the so-called rights of termination did not survive but were nullified and abrogated by the Modification Agreements. In this connection the respondent, while admitting that the Tax Court held that the issue here presented was "apparently" controlled by the rule in *Journal Publishing Co. v. Commissioner,* 3 T. C. 518 (Resp. Br. p. 26) goes on, however, to state that the Tax Court in this case below "recognized" that the taxpayer's right to terminate the agreement and thereby to discharge itself from the obligation to make further monthly payments had the same effect in this case as did the taxpayer's duty not to compete in *Journal Publishing Co. v. Commissioner, supra.* (Resp. Br. p. 27.) There is absolutely nothing in the opinion of the Tax Court in this case which would justify such a statement by the respondent, and no such interpretation is possible. Indeed, the Tax Court in its opinion in this case completely fails to point out wherein the contracts here involved are in any way similar to the contract involved in *Journal Publishing Co. v. Commissioner, supra.* Indeed, it is the contention of the petitioner that herein lies the essence of the Tax Court's error. Had the Tax Court taken the trouble to compare the obligations of the petitioner under the Modification Agreements with the obligations of the taxpayer under the contract involved in *Journal Publishing Co.,* it would have seen the distinction and would not have been able to distinguish the case of *Aetna Oil Co. v. Glenn* (1944), 53 Fed. Supp. 961, as did the Tax Court in *Journal Publishing Co.* The Tax Court in *Journal Publishing Co.* did not hold that a contract could not also be a note. It held merely that the contract there in question was not a note. Indeed, it took great pains to do so and in distinguishing *Aetna Oil Co. v. Glenn,* *supra,* it at least recognized the possibility that a contract could be a note, if not in fact impliedly so holding. The respondent's attempt to lead this Court to believe that the Tax Court below "recognized" that the petitioner after December 28, 1950 had any right of termination is indeed regrettable. As the petitioner has pointed out previously herein, the Tax Court in this case below found both that the Modification Agreements created new obligations to make payments of *sums certain* over specified shorter periods of time [R. 42], and that "no title was reserved by the transferor so far as we can see and petitioner *did not impose any conditions as to payments* except to specify the time when they should be made." [R. 48.] (Emphasis supplied.)

The second string to the respondent's argumentative bow in this respect is the general proposition that contracts cannot be "notes". Obviously, the respondent attempts to continue and compound the confusion caused by the Tax Court's opinion below.

At page 20 *et seq.* of its opening brief the petitioner sets forth several of the legally accepted definitions of a "note". Except for differences in wording, such definitions are as follows: "A written promise to pay a certain sum of money at a future time unconditionally." Except for its argument concerning rights of termination which are answered above, the respondent fails entirely to point out wherein the specific written instruments here involved do not meet every legally accepted definition of a note, nor does the respondent cite one case wherein its has been held that a written instrument, whether called a contract, agreement, or otherwise, which contains the essential elements of a note is not a note within the legally accepted definition of that term.

In *Consolidated Goldacres Co. v. Commissioner*, C. A. 10th (1948) 165 F. 2d 542, cited by the respondent, the Court was considering documents entitled "contracts of conditional sale". The Court after rather thoroughly reviewing the Tax Court's decision in *Journal Publishing Co. v. Commissioner, supra,* did exactly what the Tax Court did in *Journal Publishing Co.* — it determined that the contracts in question did not contain an unconditional promise to pay a certain sum of money at some future time. In its decision the Court pointed out that the Tax Court in *Journal Publishing Co.* had adopted the ordinary legal definition of the word "note" as "a written promise to pay a certain sum of money at a future time unconditionally." 165 F. 2d at 544. The Court also noted that the Tax Court in *Journal Publishing Co.* had recognized that a note need not be in any particular form. Then, after finding that the conditional sales contracts in question were bilateral in nature and that the obligation imposed upon the taxpayer therein was not unconditional and unilateral, stated as follows:

> "It is thus manifestly plain that the contract not having the attributes of an ordinary note cannot be so construed under Section 719(a)(1)." 165 F. 2d at 545.

It is submitted that the Court in *Consolidated Goldacres* was of the opinion that a written contract which does contain the essential elements of a note does meet the ordinary legal definition of a note and would therefore be a note. The Court in that case was not satisfied to say that a contract cannot be a note and to rest its decision on that basis.

Also in *Bernard Realty Co. v. United States,* C. A. 7th (1951) 188 F. 2d 861, cited by the respondent, the Court was not satisfied to rest its decision on the doctrine that a contract could not be a note but, on the contrary, found it necessary to find that a Wisconsin land contract was in effect bilateral and executory on both sides and that therefore the promise to pay contained therein was not unconditional.

The language quoted by the respondent from *Frankel and Smith Beauty Departments, Inc. v. Commissioner,* C. A. 7th (1948) 167 F. 2d 94 is pure dictum since the contention to which the Court was referring and which was propounded by the taxpayer was not contested by the Commissioner. However, here again the Court found it necessary to determine that the promise to pay contained in a lease was not unconditional and that, therefore, a note did not exist.

In both *Consolidated Goldacres Co. v. Commissioner, supra,* and *Bernard Realty Co. v. United States, supra,* the taxpayers were in effect arguing that the documents in question were in legal effect *equivalent to* the prescribed types of evidence of indebtedness contained in Section 719(a)(1) of the World War II Excess Profits Tax Law. The petitioner herein does not contend that the Modification Agreements are equivalent to notes—it contends that the Modification Agreements are notes within every legally accepted definition of that term.

The case of *United States v. Ely and Walker Dry Goods Co.,* C. A. 8th (1953) 201 F. 2d 584, was cited by the petitioner in support of its contention that promissory notes within the purview of the Revenue Acts can contain other provisions of substance and are not necessarily limited to some short form mercantile document. The Court in *United States v. Ely and Walker Dry Goods Co., supra,* does quote from the Second Circuit's opinion in *General Motors Acceptance Corp. v. Higgins,* 161 F. 2d 593, but in doing so is distinguishing it, and in so doing points out that in substance thirty million dollars of long-term promissory notes issued to a few large investors who were in the market for the purchase of such securities for investment were held in the light of the transaction of which they were a part to be securities rather than promissory notes. The Court in *United States v. Ely and Walker Dry Goods Co., supra,* also states the well established rule that ". . . Taxation is concerned with substance and not with formalities. The substance of the transaction which a document or instrument evidences and not the label of the instrument controls."

Such was the effect of the decision in *Brewster Shirt Corporation v. Commissioner,* 159 F. 2d 227 (C. A. 2d), wherein the Court held that factoring agreements were "equivalent to" a mortgage. In commenting on the decision in the *Brewster Shirt Corporation v. Commissioner, supra,* case, the respondent suggests that it has been impliedly overruled by the decision in *Frankel and Smith Beauty Departments, Inc. v. Commissioner, supra.* Such is, of course, not the case. As pointed out above, the decision in *Frankel and Smith Beauty Departments, Inc. v. Commissioner, supra,* was merely to the effect that the lease there involved did not contain an unconditional promise to pay, and that such document could not therefore be considered a note. Nothing in the Court's opinion casts any doubt on *Brewster Shirt.*

The respondent readily admits that it cannot distinguish the case of *Aetna Oil Company v. Glenn, supra.* All the respondent does, as it attempts to do with respect to the case of *Brewster Shirt Corporation v. Commissioner, supra,* is to question its authority. In spite of its attempts to do so, the respondent fails entirely to make an inroads upon the well reasoned opinion of Judge Shackleford Miller, Jr., now a Judge of the Court of Appeals for the Sixth Circuit. The *Aetna Oil Company v. Glenn, supra,* case stands squarely for the proposition that a written document, no matter what its label, which contains the essential elements of a note is a note.

In closing its brief, the respondent attempts to explain away the implied holding of *Journal Publishing Co. v. Commissioner, supra,* to the effect that a written contract which contains an unconditional promise to pay and meets the other requirements of a "note" should be treated as a note within the section involved in that case which was the precursor of the section involved in the instant case. The respondent attempts to do this by stating that the Tax Court in *Journal Publishing Co.* relies on *Aetna* to confirm the Tax Court's view that a conditional obligation cannot in any event constitute a note. The Tax Court did not need *Aetna* to do this—it had cited ample authority for such proposition earlier in its decision. The Tax Court in *Journal Publishing Co.* obviously found it necessary to distinguish the contract involved in *Journal Publishing Co.* from the contract involved in *Aetna* in order to avoid the holding of *Aetna,* which it in no way questioned at all.

Finally, the respondent's brief fails entirely to successfully meet the contentions of the petitioner (1) that the obligations of the petitioner, as evidenced by the Modification Agreements of December 28, 1950 constituted an "outstanding indebtedness," and were evidenced by "notes", as both of those terms are used in Section 439(b)(1) of the 1939 Internal Revenue Code. The petitioner's obligations under the Modification Agreements are not rendered conditional by any rights of termination which were included in the prior License Agreements. Such rights were abrogated and nullified by the Modification Agreements. The Modification Agreements do constitute notes according to every legally accepted definition of that term. And none of the cases cited by the respondent contain a precedental holding to the effect that a written instrument which contains the essential elements of a note cannot be considered as a note for the purposes of the statute involved or any precursor statutes thereof. In fact, many of the cases cited, and the conclusion to be reached from the aggregate thereof, hold that a written contract can be and is a note if in fact it contains all of the essential elements thereof.

Conclusions.

For the reasons stated above and in the petitioner's opening brief, the decision of the Tax Court with respect to the issue involved herein is erroneous, should be reversed, and the case remanded to the Tax Court for a determination of the petitioner's correct income tax liability for the years here involved.

Respectfully submitted,

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James E. Harrington,
Attorneys for Petitioner.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Wilson B. Copes